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The Coroner's Inquest: Ecuador's Default and Sovereign Bond
Documentation

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Abstract

Conventional wisdom is that sovereigns will rarely, if ever, default on their external debts in circumstances where it is clear that they have the capacity to pay. The first line of defense against the errant sovereign is its concern about reputation. It may have to tap the external debt markets again in the future; and there is the fear that the markets will extract revenge. But reputational constraints do not always work because some governments heavily discount future costs in favor of current benefits. When reputational constraints fail, however, a second line of defense is supposed to come into play. That line of defense is comprised of contractual and legal remedies. Both lines of defense broke down in the case of Ecuador's default in late 2008. The breakdown of the second line of defense is significant because this was the first time that the modern theory of supermajority creditor control of sovereign debt problems was tested in practice. This Article begins the coroner's inquest into the reasons for this breakdown and how similar situations might be averted in the future.

^{*} Cleary Gottlieb Steen & Hamilton LLP, New York. Cleary Gottlieb represented the Republic of Ecuador in the issuance of its bonds in 1995, 1997, 2000 and 2005, but the firm had no involvement in Ecuador's default of 2008 or the ensuing buyback offer described in this article.

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Introduction

In late 2008, the Republic of Ecuador defaulted on its international bonds. This was not a novel occurrence. In a study published in 1993 ("The Risks of Sovereign Lending: Lessons from History," Sept. 1993), Salomon Brothers concluded that Ecuador had the worst debt performance record of any of the 70 payment-challenged countries they surveyed. There have been two additional defaults since 1993. But this latest default was certainly different. Two highly concessional debt restructurings (one in 1995 and the second in 2000), together with record high oil prices, had left Ecuador in 2008 with an enviably manageable external debt profile.

The motivation for this default was domestic politics, not financial necessity. It was the first time in modern history that a sovereign debtor had demanded that its external commercial creditors write off most of their claims (65 percent, as it turned out), without advancing a plausible argument that financial distress warranted such extraordinary debt relief.

The demise of the doctrine of "absolute" sovereign immunity in the second half of the last century left sovereign debt markets operating on the assumption that the menacing prospect of legal enforcement of debt contracts, coupled with a fear of market exclusion and the prospect of a censorious raised eyebrow from the multilateral financial institutions, would act as an effective brake on casual sovereign defaults. In the Ecuador case, however, the system designed to protect the interests of the bondholders against such a default failed. The creditors were left with no feasible option apart from knuckling under to a demand that they forgive 65 percent of their

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claims against a sovereign debtor that visibly had the resources to continue servicing those obligations.

The questions now are how could this have happened and what needs to change in order to ensure that the traditional legal balance between sovereign debtors and their commercial creditors is restored?

The Historical Context

There has been a steady movement over the last 15 years toward supermajority creditor control of sovereign debt workouts. The textual evidence of this is visible in the documentation used for the issuance of bonds by emerging market sovereigns. For example:

- Acceleration of bonds following an event of default now typically requires a vote of at least 25% of the bondholders (as opposed to the traditional format that permitted each bondholder to accelerate its own bonds following an event of default).
- Collective action clauses, first introduced into New York law sovereign bonds in 2003, are now standard in most emerging market sovereign bonds. These clauses permit the payment terms of the bonds to be amended with the consent of 75% of the bondholders. Prior to this innovation, the payment terms of a New York law-governed sovereign bond could not be altered without the unanimous consent of the bondholders.
- An increasing number of these bonds are being issued pursuant to trust indentures in the New York market and trust deeds in the London market (in contrast to the fiscal agency structures used in prior periods). Trustees represent the interests of the bondholders; fiscal agents are agents of the issuer of the bonds and owe no fiduciary duties to the bondholders.
- Most recently, several New York law trust indentures for sovereign bonds have centralized all powers to enforce the bonds in the hands of the trustee. The traditional U.S. practice (an invariable practice in corporate bonds) permits each bondholder to sue for its share of a payment that was not made on a scheduled maturity date. Full centralization of enforcement powers in the hands of the trustee has long been the norm in English law trust deeds.

The principal motivation for these documentary changes was a desire to replicate, in the sovereign context, the supermajority creditor control of debt workouts that exists in most corporate insolvency regimes. If unforeseen circumstances prevent normal servicing of the debts, the proponents of this approach argued, the judgment of the large majority of the creditors should control whether and how to adjust payment terms in response to those circumstances. Individual creditors should not be given an opportunity to disrupt a consensual restructuring or to exploit the concessions granted by the vast number of their fellow lenders.

Supermajority creditor control, however, never implied that bondholders would forfeit their rights to enforce their claims through legal proceedings. In particular, the movement toward the use of trust structures for emerging market sovereign bonds was not intended to dilute creditors' legal rights, but merely to centralize those powers in the hands of a trustee who would exercise those rights for the ratable benefit of all creditors. Naturally, this approach assumed that the entity appointed to exercise these centralized powers (the trustee) would, if and when necessary, acquit itself of its duty to preserve, protect and defend the interests of the bondholders.

These assumptions, and this legal architecture, were tested for the first time in connection with Ecuador's 2008 default on two series of its bonds and the country's subsequent offer to repurchase those bonds at a very deep discount. As things turned out, the assumptions proved to be fragile and the legal architecture failed in its principal purpose.

The Default

The latest Ecuador default had its origins in the Ecuadorian presidential election of 2006. One of the candidates, Rafael Correa, campaigned on a platform that implicitly promised to redirect into social programs a large portion of the money that Ecuador devoted to making payments on its external debt. The fly in the buttermilk, as Correa (an economist by training) must certainly have known, was that Ecuador's debt burden was actually quite manageable. The country had, just the year before (2005), issued bonds in the international markets highlighting its very favorable debt ratios. Correa himself had been the Ecuadorian Minister of Finance for a portion of 2005 while that bond issue was being prepared.

Correa's campaign message found favor with the Ecuadorian electorate and he became President of the country in January 2007. Lacking a financial justification for demanding concessions from the country's creditors, the Correa administration decided that it would seek a legal pretext

for its hostile debt policy. The slogans for this were lying conveniently at hand courtesy of the academic debate about the early twentieth century doctrine of “odious” sovereign debts; a debate that had rekindled following the ouster of Saddam Hussein in 2003. The original (circa 1927) doctrine defined odious debt very narrowly, too narrowly it seems for the taste of some modern commentators. This may explain the shift in terminology toward an even less precise, but apparently more inclusive, category of “illegitimate” debts.

Shortly after taking office in 2006, Correa appointed a “Commission of Integral Audit of Public Credit” and ordered it to examine Ecuador’s foreign debts. That Commission, composed principally of local and foreign activists for third world debt cancellation, duly reported its finding that virtually all of Ecuador’s external debt stock was fatally tainted by illegality and illegitimacy.

The Commission’s standards for identifying illegitimate/illegal debts were always original and occasionally risible. To give just a flavor, the Commission concluded that the wickedness, corruption and incompetence of Ecuador’s debt negotiators over the prior 30 years were revealed by the negotiators’ supine acceptance of contractual provisions such as a choice of foreign governing law, submission to foreign court jurisdiction and waiver of sovereign immunity.

When the Correa administration took office, Ecuador had three outstanding international bond issues, two had been issued in 2000 as part of the settlement of Ecuador’s last default on its Brady Bond and Eurobond debt. Shortly after the official release of the Commission’s report, Ecuador ceased payments on both of these bonds. A third external bond, issued in 2005 (the year in which Correa had served a stint as finance minister), continued to be serviced.

The Buyback Offer

Following the default in November 2008, the market price of Ecuador’s bonds sank into the low 20s (the bonds had been trading at or close to par as recently as end-2007.) Rumors quickly circulated that the Government of Ecuador had embarked on a program to acquire (through two financial intermediaries) between 30-50% of the total outstanding amount of the two defaulted bonds at the deeply discounted prices occasioned by the Government’s default and threats of default.

On April 20, 2009, six months after the first default, Ecuador launched a cash buyback offer to repurchase the two series of defaulted bonds. The transaction was structured as a modified Dutch auction with a minimum price of 30 cents on the dollar of outstanding principal.

The disclosure document that accompanied the buyback offer had several features that bear upon this story:

- The Government utterly repudiated the two bonds it was seeking to repurchase; holders were told that Ecuador had no intention of ever resuming normal payments on those instruments.
- Although the indenture governing the two defaulted bonds expressly treated any bonds owned or controlled directly or indirectly by Ecuador as “not outstanding” for voting purposes, the offering document failed to disclose whether any bonds were then under the ownership or control of Ecuador and, if so, how many.
- Ecuador threatened in the offering document to place the repurchased bonds in the hands of a nominee whom “the Republic does not control”, and then to convene a bondholders’ meeting for the purpose of amending (unspecified) provisions of the old bonds. The fatuity of the proposition that Ecuador would hand over the repurchased bonds to a truly independent, “vote your conscience”, custodian did not diminish the potency of the threat that the Government would try to circumvent the indenture’s protections in this regard.
- Any doubt that this was a “willingness to pay”, not a “capacity to pay,” driven default was removed by a perusal of the disclosure document. External debt to GDP, for example, was disclosed to be less than 20% and total debt to GDP stood at 26.1%. By contrast, Ecuador’s debt to GDP at the time of its prior debt restructuring in 2000 was 100.5%.
- The disclosure document was accompanied by a transmittal letter from the Ecuadorian Minister of Finance. The Minister characterized the findings of the Commission of Integral Audit concerning the illegality/illegitimacy of Ecuador’s

The Theory

The trust indenture that governed the two series of defaulted Ecuadorian bonds set out the bondholders' legal remedies following a default. Holders of 25% (in principal amount) of each series could accelerate their series by notice to the trustee. The indenture, however, carefully preserved for the trustee the discretion to accelerate the bonds on its own volition, without waiting for a bondholders' vote. This power was presumably to be exercised in extreme cases when time was of the essence or the character of the default and the issuer's intentions were unambiguously hostile to the interests of the bondholders.

To safeguard the integrity of this voting process, the indenture treated as "not outstanding" any bonds owned or controlled, directly or indirectly, by the issuer. If the trustee was in any doubt about whether the issuer had reacquired its own bonds, the indenture gave the trustee the power to demand a certification to this effect from the issuer. The issuer was required to respond "promptly".

Following the occurrence of an Event of Default, the trustee was given the discretionary power "to protect and enforce the rights vested in it by this Indenture by such appropriate judicial proceedings as the Trustee shall deem most effectual ...". Apart from this discretionary authority, an enforcement action for the recovery of an accelerated amount required the holders of 25% of the outstanding bonds of a series to request the trustee to commence such an action and to offer the trustee an indemnity against its costs, expenses and liabilities incurred in doing so. The indenture specified that the trustee had 60 days in which to decide whether it would enforce the bonds after receiving such a request; if the trustee failed to do so within this time period, enforcement rights reverted to the bondholders.

The Reality

Practice did not live up to theory. Even though the issuer had publicly repudiated the instruments (it's hard to imagine a more serious provocation), the trustee did not exercise its discretion to accelerate either series of bonds or to commence an enforcement action. The holders of one series eventually mustered the 25% vote needed to force the trustee to accelerate that series, but the authors understand that the second series missed the 25% voting threshold by just a small amount.

Because any bonds owned or controlled by Ecuador should have been deemed "not outstanding" for purposes of these votes, the trustee never actually knew the size of the universe of bondholders entitled to vote for acceleration or to request an enforcement action. And without knowing the denominator of the voting fraction, the trustee obviously could never ascertain whether the votes it had received constituted the necessary 25%.

The authors understand that the trustee asked for a prompt certification from Ecuador as to the number of bonds it owned or controlled; a demand that Ecuador seems to have ignored. The trustee was apparently not prepared to draw a negative inference from this further breach of the indenture and continued its policy of refusing to accelerate the instruments on its own volition. (By way of comparison, the trustee for Ecuador's 1997 Eurobonds did accelerate those bonds on its own volition.)

Now in a normal situation -- one in which a borrower stops paying its debts because it lacks the money to do so -- this passivity on the part of the trustee may have just delayed what would in any event have been a painfully drawn out enforcement process. But Ecuador was far from being an impecunious debtor, as evidenced by the fact that within six months of the default it had launched a cash tender for its own bonds. Once the buyback operation was announced, everyone knew that within a matter of a couple of months the issuer would be forced to mobilize -- at a specific place on a specific day -- the hundreds of millions of dollars needed to close the buyback with the tendering bondholders.

Whether those funds could have been shielded from attachment by an aggressive trustee is a question to which we shall never know the answer. But this much seems certain -- the closing of the cash buyback represented the first, the best and perhaps the only opportunity for the creditors to recover a sizeable portion of their claims. The trust indenture

deprived the individual bondholders of their ability to pursue legal remedies on their own; they were thus wholly reliant on the trustee's vigilance and enterprise to protect their interests.

When it became clear that their contractually-appointed champion was not eager to enter the lists, most of the bondholders apparently felt that they had little choice but to accept Ecuador's buyback offer. The final price of 35¢ on the dollar was accepted by holders of approximately 91% of the bonds.

Contractual Changes

Was this just an isolated case of a bovinely passive trustee, or should there be changes in the standard forms of New York law trust indentures for sovereign issues that would prevent this sort of mischief from recurring?

Trustee Responsibilities. The form of trust indenture that has been used for the last ten years for sovereign bond issues differs in one very material respect from the trust indentures used for publicly-issued corporate debt securities in the United States. The latter, reflecting an explicit requirement of the U.S. Trust Indenture Act of 1939, imposes on a trustee only administrative duties -- right up to the point that an event of default has occurred. After a default, the trustee's fiduciary responsibilities ratchet up sharply. A trustee for a corporate debt issue, confronted with a default, must exercise such of the rights and powers vested in it by the indenture, and use the same degree of care and skill in their exercise, as a prudent man would use under the circumstances in the conduct of his own affairs. This is a fairly high fiduciary standard.

A contractual provision mandating a higher post-default standard of trustee responsibility is missing from the form of trust indenture that has been used for New York sovereign bond issues, including the two defaulted Ecuador bonds. At some point in its drafting history, someone (probably a lawyer representing a trustee) realized that sovereign trust indentures do not need to comply with the requirements of the U.S. Trust Indenture Act. That drafter accordingly seized the opportunity to strip out of the document the provision that contains the living, beating heart of a trustee's contractual fiduciary duty to its debtholders. And after this bit of surgery, the document was replicated again and again for future deals, as standard financial contracts often are. Whatever one's views about the propriety of the trustee's behavior in the recent Ecuador affair, therefore, the

trust indenture in question did not require more aggressive action by the trustee.

The Ecuador case demonstrated how a sovereign debtor can exploit this documentary weakness if it is determined to do so. The authors can see no reason why trust indentures used for future sovereign issues should not follow the corporate model and impose more stringent responsibilities on a trustee to protect the interests of the debtholders once the instrument goes into default.

Orphans and Mercy. When a secondary market in the trading of commercial bank loans to sovereign borrowers began in the mid-1980s, the banks quickly realized that it invited howling moral hazard. A sovereign debtor could default on its interest payments, drive down the secondary market price of its paper and then use the money it should have paid in interest to repurchase and cancel the debt in full. Default thus became the enticing prelude to sound debt management. The phenomenon was described in these pages (IFLR, April 1991 at 10,11) as being equivalent to the old saw about the boy who murders his parents and hurls himself on the mercy of the court as an orphan.

The banks tried to arrest this temptation by including clauses in their restructuring agreements that forbade a borrower from directly or indirectly acquiring interests in its own debts at any time that those loans were in default. The banks recognized, of course, that a borrower willing to default on a loan might not balk at breaching a covenant of this kind. But the banks believed that third-party financial intermediaries -- the ones who quietly repurchased debts on the secondary market for sovereign clients -- would be reluctant to collude in such an explicit breach.

These prohibitions against a borrower repurchasing its defaulted debts were carried over into the Brady bonds that replaced the commercial bank loans in the early 1990s. Ecuador's Brady bonds, for example, had just such a restriction. The clauses were unobtrusively dropped, however, from the new Eurobonds and Yankee bonds issued by these countries later in the 1990s. The justification, if there was one, must have been that no sovereign bond issuer would risk its market reputation by deliberately defaulting in order to manipulate the price of its bond to its own benefit.

That theory is probably correct, but it does not account for the possibility that politicians in the debtor country might order a cessation of payments for domestic political reasons. In these circumstances, the legal

ability to repurchase defaulted debts makes the debtor the principal beneficiary of its own default. Add a deliberate concealment of the true beneficial ownership of the bonds to frustrate syndicate voting, a complaisant trustee and a widely-dispersed bondholder class, and the result can be an effective emasculation of creditor legal remedies.

Sovereign Defaults

The 1993 Salomon Brothers study referred to in the opening paragraph of this article ended with a comforting assurance to prospective investors in sovereign debt paper. “Countries do not default lightly,” said the Salomon report. “The cases of pure ‘unwillingness to pay’ are few and occur under circumstances of extreme political instability.”

That conclusion accurately summarized the prior 200 years of historical sovereign debt performance. If the Ecuador example proves infectious, it may be accurate no longer.

Ecuador Indenture Version

Duties and Responsibilities of the Trustee

The Trustee undertakes to perform such duties and only such duties as are specifically set forth in this Indenture and the Terms. No provision of this Indenture shall be construed to relieve the Trustee from liability for its own grossly negligent action, its own grossly negligent failure to act or its own willful misconduct, except that:

- (a) (i) the duties and obligations of the Trustee shall be determined solely by the express provisions of this Indenture, and the Trustee shall not be liable except for the performance of such duties and obligations as are specifically set forth in this Indenture, and no implied covenants or obligations shall be read into this Indenture against the Trustee; ...

* * * *

Recommended Version^{*}

Duties of Trustee

- (a) If an Event of Default has occurred and is continuing, the Trustee shall exercise such of the rights and powers vested in it by this Indenture, and use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.
- (b) Except during the continuance of an Event of Default:
 - (i) The Trustee need perform only those duties that are specifically set forth in this Indenture and no others. ...

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^{*}From American Bar Association, Model Simplified Indenture.